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SUPREME COURT

COMMONWEALTH OF KENTUCKY
SUPREME COURT
NO. 2013-SC-00497-D

NOBE BAKER, et al. APPELLANTS

v.

ON REVIEW FROM
THE KENTUCKY COURT OF APPEALS
NO. 2012-CA-001016-MR

HARLAN CIRCUIT COURT
THE HONORABLE JAMES L. BOWLING, JR.
CIVIL ACTION NO. 11-CI-00310

MAGNUM HUNTER PRODUCTION, INC. APPELLEE

BRIEF FOR APPELLEE

Anne A. Chesnut
R. Clay Larkin
BINGHAM GREENEBAUM DOLL LLP
300 West Vine Street, Suite 1100
Lexington, Kentucky 40507
Telephone: (859) 231-8500
Facsimile: (859) 255-2742

Harry D. Callicotte
MAGNUM HUNTER PRODUCTION, INC.
120 Prosperous Place, Suite 201
Lexington, Kentucky 40509
Telephone: (859) 263-3948
Facsimile: (859) 263-4228

COUNSEL FOR APPELLEE

CERTIFICATE OF SERVICE

This is to certify that on this 13th day of October, 2014, true and correct copies of this Brief were sent by first-class mail, U.S. postage prepaid, to: Samuel P. Givens, Jr., Clerk, Kentucky Court of Appeals, 360 Democrat Drive, Frankfort, KY 40601; Clerk, Harlan Circuit Court, P.O. Box 190, Harlan, KY 40831-0190; Hon. James L. Bowling, Jr., Special Judge, 113 Wellington Drive, Middlesboro, KY 40965; John C. Whitfield, Whitfield Bryson & Mason, LLP, 19 N. Main Street, Madisonville, KY 42431 and George E. Stigger, 236 Cardinal Circle W., St. Mary's, GA 31558, Counsel for Appellants; Karen J. Greenwell and G. Brian Wells, Wyatt, Tarrant & Combs, LLP, 250 W. Main Street, Ste. 1600, Lexington, KY 40507, Counsel for Kentucky Oil and Gas Association; and James L. Hamilton, Hamilton & Stevens, PLLC, 117 Caroline Avenue, Pikeville, KY 41501-1101, Counsel for National Association of Royalty Owners.

Anne Chesnut
COUNSEL FOR APPELLEE

INTRODUCTION

Appellants ask this Court to rewrite their oil and gas leases in a way completely unsupported by Kentucky law or common sense. The Circuit Court and Court of Appeals both properly declined to do so, and they should be affirmed here.

STATEMENT CONCERNING ORAL ARGUMENT

Appellee does not object to Appellants' request for oral argument.

COUNTERSTATEMENT OF POINTS AND AUTHORITIES

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COUNTERSTATEMENT OF THE CASE

I. BACKGROUND

Appellants (sometimes referred to herein as "Plaintiffs") alleged in Count I of their Complaint[1] that Appellee Magnum Hunter Production, Inc. ("Magnum Hunter") should not be entitled to deduct certain "costs and expenses incurred in the gathering, compression and treatment of gas" when calculating royalty due to the Plaintiffs under their written leases. Plaintiffs alleged in a separate count, Count IV, that gas was not being produced in "paying quantities," even though they admitted on the face of their Complaint that gas was being produced from the wells under lease and that they were regularly receiving production royalty.

Plaintiffs recognized that both of these claims presented only legal issues and even sought in Count IV a declaration of rights from the Court on both issues (including the royalty calculation issue raised in Count I). The Harlan Circuit Court, with Special Judge James L. Bowling presiding, dismissed these Counts on the uncontroverted record before him. (A copy of his Order is attached as Appendix A.) Appellants did not argue below that any factual issue existed and they do not argue that on this appeal. They simply disagree with long-established Kentucky law.

II. UNDISPUTED FACTS

The following facts, most of which came from Plaintiffs' own Complaint, were undisputed:

1. Plaintiffs are the lessors under a pair of oil and gas leases described as the "Baker Lease" and the "Jackson Lease." (*See* Complaint at ¶¶ 8-9.) (The Complaint is attached as

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[1] For brevity, the "First Amended and Restated Complaint (Revised)" is referred to herein as "the Complaint."

Appendix B.) Because the provisions of the Baker Lease and Jackson Lease relevant to this appeal are substantively identical, the two agreements are referred to herein collectively as the "Leases."

2. Magnum Hunter is the lessee under the Leases.

3. The Leases grant Magnum Hunter the right to produce natural gas from the premises covered by the Leases, which Magnum Hunter has done and continues to do. In return, the Leases require Magnum Hunter to pay Plaintiffs a royalty. The Gas Royalty provision of the Leases provides in relevant part that Magnum Hunter shall:

> pay Lessors **one-eighth of the market price at the well** for gas sold or gas so used from each well off the premises, …

(Emphasis added).

4. The Leases further provide that:

> It is agreed that this lease shall remain in force and effect for a term of [one (1) year for the Baker Lease and three (3) years for the Jackson Lease] from this date and as long thereafter as oil, gas, casing-head gas, casing-head gasoline or any of them is produced from said leased premises…

5. Natural gas is produced by drilling wells into subterranean reservoirs of gas, and drawing this gas to the surface by use of a well and its associated equipment. Plaintiffs alleged at ¶ 17 of their Complaint that "the gas produced by the Defendant is not marketable or salable at the wellhead where it is produced." Accordingly, the gas must be transported, typically via pipeline, to a purchaser. *See Schroeder v. Terra Energy, Ltd.*, 565 N.W.2d 887, 891 (Mich. App. 1997) (noting that "natural gas is not typically sold at the wellhead.").

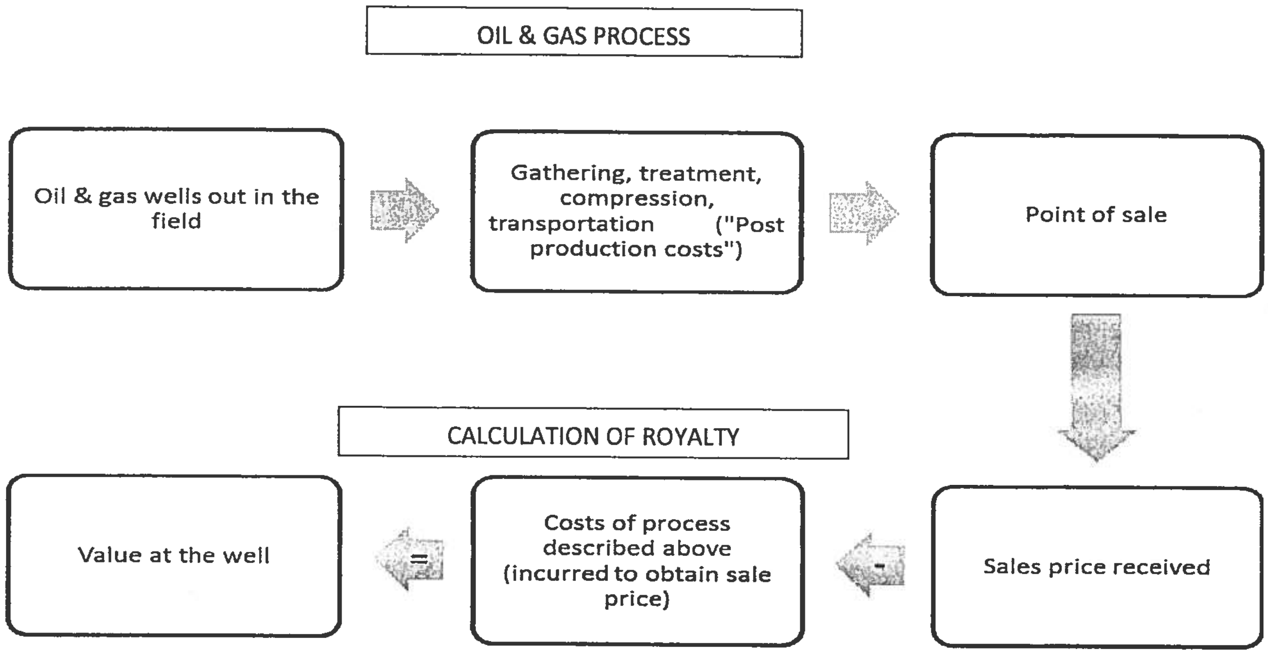
6. In order to transport and market gas, it must first be gathered, compressed, and treated. (Complaint at ¶ 14, referring to the "gathering, compression, and treatment necessary for such gas to be sold and marketed.")

7. "Gathering" is the process of "collecting gas at the point of production (the wellhead) and moving it to a collection point for further movement through a pipeline's principal transmission system." *See* Williams & Meyers, *Oil and Gas Law*, Terms 8-G (Lexis Nexis Matthew Bender 2013).

8. "Compression" is the process of raising the pressure of gas; compression is used to transport low pressure gas through the pipeline to the place where it can be sold. *See Merritt v. Southwestern Electric Power Co.*, 499 So.2d 210, 213 (La. Ct. App. 1986) ("In order to market the gas, it first had to be compressed. Thus, the gas was useless and had no market value at the wellhead until it could be moved into the gathering line by compression.").

9. "Treatment" refers to the removal of harmful substances from gas to enhance its value or to make the gas acceptable for receipt by a pipeline company or other purchaser. *See e.g.*, R. Sutton, *Annotation, Sufficiency of "At the Well" Language in Oil and Gas Leases to Allocate Costs*, 99 A.L.R. 5th 415 § (2008) ("Due to the need, in some cases . . . to treat the gas to remove harmful substances or to enhance its value, several cases have discussed the allocation of compression and treatment costs between lessor and lessee").

10. Plaintiffs complained that, when calculating the amount due under the Gas Royalty provision of the Leases, Magnum Hunter takes the price it receives for gas produced and sold from the Leases, and works backwards from the price to deduct the costs it incurs in gathering, compressing, and treating the gas, all necessary to get that price. (Complaint at ¶ 14.) This is sometimes called a "workback" or "at the well" method of calculating royalty and is illustrated as follows:



Thus the gas and the calculation move in opposition directions, as illustrated above. The oil and gas are developed and moved to market (left to right above) with the actual sales price only determined at the point of sale. From there, royalty is calculated by working backwards (right to left above), taking into account what costs were incurred to obtain the sales price, and thus arriving back at the well, with the value at the well.

III. <u>CRUX OF THE DISPUTE</u>

At the heart of this case is the reference in the Leases to "market price at the well"-- a phrase so long used and established in law and practice that Black's Law Dictionary defines it as the

> **value** of oil and gas **at the place it is sold, minus the reasonable cost of transporting it and processing it** to make it marketable.

9th ed. 2009 (emphasis added).[2] Kentucky law is in complete accord with Black's definition and has been since at least 1929:

> The **value** at the place of production **is the selling price less the cost of transportation to the place of sale.**

Cumberland Pipe Line Co. v. Commonwealth, 15 S.W.2d 280, 284 (Ky. 1929).[3]

Thus the law in Kentucky has always been that the calculation of "market price at the well" works **backwards** from (1) the sales price received wherever the market for gas exists, (2) and **subtracts** what it costs to get it there.[4] This simple formula results in the "value at the place of production." *Id.* It can be illustrated as follows:

Selling price at market
- Costs of getting gas to market
Market price at well ("value at place of production")

Cumberland Pipe Line, 15 S.W.2d at 284. This is easily applied in the present case:

Selling price received by Magnum Hunter
- Costs incurred by Magnum Hunter in getting gas to market (gathering, treating, compressing, transporting)
Market price at well (on which royalty is based)

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[2] This same definition also appeared in earlier editions of Black's in 2004, the year when the leases were executed. See Appendix C.

[3] Appellants concede that "market price" and "market value" are synonymous. Appellants' Brief, p. 9, n. 3 ("slight variation in....phrasing" is "a distinction without a difference.")

[4] Unlike the *Appalachian Land Company* case set for oral argument on the same date as this one, this case does not involve any severance tax issues, but is limited to gathering, compressing, and treating gas so that it can be transported.

But Appellants argued below for a completely different result, not supported anywhere in Kentucky law, that would have looked like this:

Selling price received by Magnum Hunter
- 0
Royalty claimed by Appellants (without taking into account costs of getting the gas to market, contrary to Kentucky law)

The Circuit Court rejected Appellants' approach, which is unsupported by Kentucky law. The Circuit Court's decision, supported by more than 80 years of Kentucky jurisprudence, was unanimously affirmed by the Kentucky Court of Appeals. (Appendix D). Those decisions should be affirmed for the reasons that follow.

ARGUMENT

I. KENTUCKY LAW ALLOWS DEDUCTION OF THESE COSTS IN CALCULATING ROYALTY.

Kentucky's highest court framed the exact question presented here in its decision in *Warfield Natural Gas v. Allen*, 88 S.W.2d 989, 991 (Ky. 1935), when it asked:

> So we can say the defendant took this gas at the well, and the question is what it must pay for it. Must it pay its value there [at the well] or must it pay what it may ultimately have got for it?

The answer follows at p. 992 of the decision, where the Court says that the defendant need only account for the value "**at the well-side** … even though it may market the gas elsewhere and get a much greater sum for it." (Emphasis added).

Appellants never address this *Warfield* holding in their brief, but they do discuss the earlier case of *Cumberland Pipe Line* at length. As in *Warfield*, the Court in *Cumberland Pipe Line* also follows the "at-the-well" rule.

A. Appellants now concede that transportation costs are properly deducted under *Cumberland Pipe Line.*

Appellants now concede, as they must, that transportation costs are properly deducted before royalty is calculated. *See, e.g.* Brief for Appellants at p. 18 ("[T]he parties are in agreement that … transportation costs should be shared proportionally"). This is the very holding of *Cumberland Pipe Line Co. v. Commonwealth*, 15 S.W.2d 280, (Ky. 1929), and, as Appellants now acknowledge, "*Cumberland Pipe Line* did get it right." (Brief for Appellants, p. 20).[5]

What *Cumberland Pipe Line* stands for is the fundamental acknowledgement – in the law, industry, practice, and common sense – that:

> The product must be carried to the markets. The value at the place of production is the selling price less the cost of transportation to the place of sale.

Cumberland Pipe Line, 15 S.W.2d at 284.

B. *Cumberland Pipe Line* cannot logically be restricted in the way Appellants now urge.

Appellants insist that *Cumberland Pipe Line* means "ONLY reasonable transportation (via the principal pipe line) of the marketable product may be deducted in the calculation and payment of the gas royalties due [Appellants]."[6] But *Cumberland Pipe Line* does not embrace

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[5] Because the Brief for Appellants does not comply with CR 76.12(4)(c)(v), it may not be apparent to this Court how Appellants' position on this issue has now changed. Appellants took the position before that *Cumberland Pipe Line* only "facially" appeared to support the workback method. Brief for Appellants in Court of Appeals, p.15 n.8. Now Appellants argue that *Cumberland Pipe Line* "got it right" but try to distinguish or limit it in a way that makes no sense.

[6] Brief for Appellants, p. 19 (emphasis in original). The Brief actually says "royalties due Poplar Creek" which is a party not involved in this case. The mistaken reference may have been taken from briefing Appellants' counsel did for a different party in a different case, *Poplar Creek Development Co. v. Chesapeake Appalachia LLC*, 636 F.3d 235 (6th Cir. 2011).

the "marketable product" concept[7] nor does it limit itself to "principal pipe line" transportation. Those are words added by Appellants, not found in the decision itself.

What *Cumberland Pipe Line* does explicitly recognize is that the product has to be moved to sell it and generate royalty for anyone:

> [I]f there be no market at a particular place[8] at which it is desired to fix the market value, then the market value is taken at the nearest point available, with adjustments to care for the cost of transportation to that market.

Id. at 284. Those "adjustments" to account for the "costs of transportation to that market" necessarily include everything required to obtain the sales price. *See also Warfield, supra* (pay royalty based on value at the well, not on price ultimately obtained.)

The Court of Appeals recognized this key point in its Opinion at p. 5, where it expressly stated:

> Appellants also argue that gathering, compression, and treatment costs should not be considered transportation and processing costs as defined in the Leases. We disagree.

Opinion, p. 5. The Court of Appeals went on to explain the basis for its disagreement, relying on *Cumberland Pipe Line* and agreeing with *Poplar Creek, supra*, (applying Kentucky law) that "gathering, compression and treatment costs [are] indistinguishable from transportation costs." Opinion, p. 5. "[B]oth gathering and compression costs are **necessarily incurred** prior to transporting the natural gas, and treatment costs **increase the value** of the gas at the market."[9]

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[7] The "marketable product" theory for which Appellants advocate is antithetical to *Cumberland Pipe Line* and other Kentucky law, as discussed in detail at Argument II, *infra*.

[8] In this case, the particular place is "at the well", as provided in the Leases.

[9] *See* Williams & Meyers *Oil & Gas Law* § 645.2(3).

Id. (emphasis added). "In line with that reasoning, here, those costs were appropriately deducted...." *Id.*

Appellants offer no real rationale for their argument to the contrary. They cite a case from the Eighth Circuit that "points out the difference between 'gathering' and 'transportation'" (Brief for Appellants, p. 18), but in doing so prove the point that "gathering" is a necessary first step "for further movement," which is "transportation." *Id.* Indeed, Appellants themselves state that gathering and compression "are two of the **necessary** preliminary steps" for the gas to be piped to market. Brief for Appellants, p. 19 (emphasis added). Appellants make this same point by judicial admission in their Amended Complaint (¶ 14, p. 5, of Appendix B), where they say, "the Defendant deducted costs and expenses incurred for gathering, compression, and treatment **necessary** for such gas to be sold and marketed." (Emphasis added).

By admitting (as they must) that these costs are "necessary for such gas to be sold and marketed," Appellants bring these costs squarely within the rule of *Cumberland Pipe Line*.

II. THE "MARKETABLE PRODUCT" RULE URGED BY APPELLANTS IS CONTRARY TO KENTUCKY LAW, HAS BEEN REJECTED ELSEWHERE, AND SHOULD ALSO BE REJECTED HERE.

The royalty specified in these Leases is for "one-eighth of the market price at the well." (Leases, Appendix E). As set forth above, this phrase is so familiar in practice and the law that Black's Law Dictionary defines it as the

> value of oil and gas at the place it is sold, minus the reasonable cost of transporting it and processing it to make it marketable.

Id. 9th ed. 2009. Also as shown above, Kentucky law is in complete accord with that definition, working **backwards** from the sales price to adjust for the costs that were incurred to get that price, as in *Cumberland Pipe Line, supra.*

Appellants are advocating what they call a "marketable product" rule, which is in direct contravention of the "at-the-well" rule. These approaches are antithetical because "at the well" recognizes that royalty is properly calculated by working back to the value "at the well", whereas "marketable product" argues for royalty based on value added after the gas moves away from the well (the sales price at the point of sale without working back to calculate value at the well).

Appellants' circular argument is this: If there is no market for gas at the well, they say, then it must be because there is no marketable product until it gets to a point of sale.[10] They then contend that Appellee has a duty **to create** a marketable product at its sole cost and expense and then they try to characterize the gathering, treatment, and compression as obligatory steps to create such a product. *See, e.g.*, Brief for Appellants, p. 13 ("'market price at the well' requires [MHP] to ... provide a marketable product which includes gathering, compression and treatment"). This begins as a muddled grammatical argument (Brief for Appellants, pp. 8-13) and then expands considerably to an "implied obligation" argument beginning on p. 21 of the Brief. Neither approach has merit for the reasons that follow.

A. Appellants' grammatical argument does not advance their cause.

Appellants devote pages 8-13 of their Brief to a rant against the purported "judicial discard of (i) the rules of English grammar, and (ii) the object of [a] prepositional phase ...." (Brief for Appellant, p. 11). The cause of this extreme frustration seems to be only that the words "market price" are not used in every instance where the words "at the well" appear.

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[10] The flaw in Appellants' argument appears right here, where they confuse **market** with a **marketable product**. The fact that there is no market at the well does not mean the product is not marketable. It just means, in the words of *Cumberland Pipe Line*, that the product "must be carried to the markets." 15 S.W.2d at 284.

It is true that sometimes the discussion in case law and scholarly commentary has been shortened to a consideration of whether a jurisdiction follows the "marketable product" concept or "at-the-well" rule. But the judicial and scholarly commentary on this is clear, regardless of which words are used in any particular sentence. The shorthand version ("at-the-well rule") does not change the substance of what all these authorities are saying: Kentucky has long determined "market value at the well" by working backwards from the sales price and deducting the costs incurred to get that sales price. *See, e.g., Reed v. Hackworth*, 287 S.W.2d 912, 913 (Ky. 1956) ("lessee need account only for the recited proportion of a sale **at the well side**, even though he may market gas elsewhere for a greater sum"); *Warfield Natural Gas v. Allen*, 88 S.W.2d at 992 ("lease must be held to mean one-eighth of the gross proceeds of a sale of the gas **at the well-side** ... even though [lessee] may market the gas elsewhere and get a much greater sum for it"); *Cumberland Pipe Line*, 15 S.W.2d at 284 ("market value" means "value at the place of production [at the well]" which is calculated by taking "the selling price **less** the cost of transportation to the place of sale"); *Rains v. Kentucky Oil Co.*, 200 Ky. 480, 255 S.W.121, 121 (Ky. 1923) (lessee "fully complies with his duty" based on price **"at the well side"**) (emphasis added in each case).

These are the cases cited by the trial court. All of them deal with market value at the well. Appellants' complaint that the full phrase was not cited in every instance does not mean that the concept was not fully treated. It just means that courts sometime use a shorter phrase.[11]

Appellants' criticism of the Court of Appeals is similarly unfounded. The Court of Appeals specifically framed the question in terms of "market price at the well" and "market

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[11] Indeed, *Cumberland Pipe Line*, which Appellants say "got it right" is indistinguishable in its grammatical interpretation.

value at the well" (Opinion, Appendix D, pp. 4,5) but is nevertheless inexplicably said by Appellants to have never undertaken "a judicial analysis of the entire phrase." (Brief for Appellants, p. 11).

For all of these reasons, Appellants' arguments grounded in what they call the "rules of English grammar" are not helpful in addressing the substantive issues of this case.

B. Kentucky follows the "at-the-well" rule and rejects the "marketable product" rule.

Turning now to the substance of the issue, the same four cases cited by Judge Bowling in his circuit court decision, and also cited by the Kentucky Court of Appeals, explain the reasoning of the Kentucky courts. Because the *Warfield* case discussed *supra* so clearly answers the exact question raised here, it is discussed first.

(1) *Warfield Natural Gas Co. v. Allen*

In *Warfield Natural Gas Co. v. Allen*, 88 S.W.2d 989 (Ky. 1935), the lease at issue required the lessee "to pay for each gas well from the time and while gas is marketed the sum of one-eighth of proceeds received from the sale thereof. . . ." 88 S.W.2d at 990. The lessee did not sell gas in the field (at the place of production) but calculated and paid royalty **as if** it had been sold in the field. The lessor, Dr. Allen, wrote to complain that he was owed more, specifically saying:

> Whatever price that you sell this gas for is what you owe me for my one-eighth.

88 S.W.2d at 990. This is the same argument Appellants make here. The Kentucky court rejected this argument and held:

> [T]his Lease must be held to mean one-eighth of the gross proceeds of a sale of the gas at the well-side, and that is all for which defendant must account **even though it may market the gas elsewhere and get a much greater sum for it.**

Id. at 992 (emphasis added). The *Warfield* court framed the question exactly as the same question presented here:

> So we can say the defendant took this gas at the well, and the question is what it must pay for it. Must it pay its value there or must it pay what it may ultimately have got for it?

Id. at 991. It answered the question in favor of the lessee (here, Magnum Hunter) by holding the defendant need only account for the value "at the well-side . . . even though it may market the gas elsewhere and get a much greater sum for it." *Id.* at 992.

If Magnum Hunter were not permitted to deduct these costs in calculating market value at the well, the holding in *Warfield* (and the other Kentucky cases discussed here) would have to be overturned, and the parties' Leases completely re-written. The *Warfield* decision holds that 1/8 of the well-side value is "all for which the [lessee] must account" under a lease providing for royalty payments based on a sales price "at the well."

If Appellants' position were adopted, Magnum Hunter would be paying Appellants far more than 1/8 of the well-side value, in contravention of the express terms of the Leases. This would re-write the "1/8 to 7/8" revenue allocation expressed in the Gas Royalty provision of the Leases. This is something the courts will not do. *See Oliver v. Louisville Gas & Elec. Co.*, 732 S.W.2d 509, 511 (Ky. App. 1987) ("A contract between parties dealing in oil and gas is subject to the same rules of construction as any ordinary contract, and courts will not undertake to write a different contract or alter terms where the parties' intent is clearly expressed.").[12]

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[12] The extent to which Appellants' position would re-write the Leases to create an undeserved windfall in complete contradiction of the parties' reasonable expectations (and contrary to dictionary usage) is set out in more detail on pp. 29-32, *infra*.

(2) *Cumberland Pipe Line Co. v. Commonwealth*

The case of *Cumberland Pipe Line Co., supra*, contains one of the earliest statements from Kentucky's courts approving of the deduction of post-production costs in determining the market value of oil. At issue in *Cumberland Pipe Line* was a state tax levied on the "market value" of crude petroleum produced in Kentucky, and whether this tax violated the Interstate Commerce Clause of the United States Constitution. In order to resolve this issue, the state's then-highest court was called upon to determine the proper method of calculating the "market value" of petroleum at the "place of production" (*i.e.* "at the well").

The *Cumberland Pipe Line* court began its analysis by noting that for oil, as with the natural gas at issue here, transportation to market was common:

> There is seldom, if ever, a market at the place of production. The product must be carried to the markets. **The value at the place of production is the selling price less the cost of transportation to the place of sale.**

Cumberland Pipe Line, 15 S.W.2d at 284 (emphasis added). Thus, the court held that to calculate the "market value" of a product such as oil or gas at the place of production, one must start with the "selling price" and deduct "the cost of transportation to the place" of sale. The court held that this method of calculating value was not new or unique, but instead "conform[ed] to the legal rules of evidence for the ascertainment of market value." *Id.* The court also relied on Kentucky cases involving the valuation of other natural resources such as coal and timber, which had recognized the same point:

> The market value of a commodity is its selling price in the usual and ordinary course of business, but, if there be no market at a particular place at which it is desired to fix the market value, then the market value is taken at the nearest point available, **with adjustments to care for the cost of transportation to that market.**

Id. (emphasis added) (citing *Campbellsville Lumber Co. v. Bradlee & Wiggins*, 29 S.W. 313 (Ky. 1895); *Log Mountain Coal Co. v. White Oak Coal Co.*, 174 S.W. 721 (Ky. 1915).

Cumberland Pipe Line clearly holds that Kentucky law allows for the deduction of costs necessary to get the oil or gas to the nearest available market where the sales price is actually obtained. Only by deducting the costs of obtaining that sales price can a proper "market value" of the gas "at the well" be calculated.

(3) *Rains v. Kentucky Oil Co.*

Even prior to deciding *Cumberland Pipe Line*, Kentucky's then-highest court had already indicated that both the lessor and lessee under a gas lease must share proportionally in the costs of getting the product to market. *See Rains v. Kentucky Oil Co.*, 255 S.W. 121 (Ky. 1923). In *Rains*, the lease at issue did not specify the location at which the gas was to be valued for purposes of calculating a royalty. The court determined, however, that in the absence of such specification, Kentucky law required that royalty be paid on the price received "at the well side." *Rains,* 255 S.W. at 122.

In *Rains*, the gas was sold by Kentucky Oil Company for "6 cents per 1000 cubic feet" to another company that then transported the natural gas ("piped and marketed the gas from the premises") to the City of Williamsburg, where it was sold at 42 cents per one thousand cubic feet. Thus it was sold in Williamsburg for a much higher price than could otherwise be obtained at the well. The lessors in *Rains* argued that they should be paid one-eighth of the price received when the gas was ultimately sold in Williamsburg, despite the fact that the company incurred considerable costs in transporting the gas to the city. Kentucky's highest court rejected the lessor's argument.

> While the lessee of a gas well may be under the duty of using reasonable effort to market the gas, we are not inclined to the view that this duty, in the absence of a contract to that effect, is so

> exacting as to require him to market the gas by obtaining a franchise from some town or city and distributing the gas to the inhabitants thereof. On the contrary, he fully complies with his duty if he sells the gas at a reasonable price at the well side to another who is willing to undergo the risk of expending a large amount of money for the purpose of distributing the gas to the ultimate consumers.

Id. *Rains* held that the lessor was not entitled to a one-eighth royalty on the sales price at a distant market, but rather, only the price that could actually be obtained at the well. It naturally follows from this holding that if the lessee expends money in enhancing or transporting the product, both the lessee and lessor must share proportionally in these costs, since those costs increase the sales price – and royalty – that the parties to the lease ultimately receive.

(4) *Reed v. Hackworth*

Yet another case relied upon by the circuit court as establishing that Kentucky law permits the deductions taken by Magnum Hunter here is *Reed v. Hackworth*, 287 S.W.2d 912 (Ky. 1956). In *Reed*, the court reiterated the rule from *Rains* and *Warfield* that in the absence of contrary express language, a lessor's gas royalty is based on the sales price at the well. The lessors in *Reed* argued, however, that they were entitled to a royalty based on the sales price received by the lessee after it constructed a pipeline to Salyersville (some distance away) and sold the gas there at a higher price. The court rejected this argument, holding that "the lessee need account only for the recited proportion of a sale at the well side, even though he may market the gas elsewhere for a greater sum." *Reed*, 287 S.W.2d at 913.

In summary, *Warfield, Cumberland Pipe Line, Rains,* and *Reed* all demonstrate that long-established Kentucky law allows Magnum Hunter to deduct its post-production costs in order to determine the "market price at the well" as that term is used in the Leases.

C. <u>Recent, consistent, and unanimous application of Kentucky law.</u>

Appellants' arguments that a lessee cannot deduct these costs in determining the market price of gas "at the well" has also been examined and rejected by several recent federal decisions applying Kentucky law.

In *Poplar Creek Development Co. v. Chesapeake Appalachia, L.L.C.*, 636 F.3d 235 (6th Cir. 2011), the Sixth Circuit held that, under Kentucky law, a lessee may deduct the costs of gathering, compression and treatment in determining the value of such gas "at the well." The lease at issue in *Poplar Creek* contained language very similar to the Leases here. Specifically, the lease in *Poplar Creek* provided for a gas royalty of "**one-eighth (1/8) part of the wholesale market value of such gas at the well** based on the usual price paid therefor in the general locality of said leased premises . . . ." *Poplar Creek*, 636 F.3d at 238 (emphasis added). Thus, when the *Poplar Creek* decision held that Kentucky law permits the deduction of these costs, it was not just stating an abstract rule, but indeed was applying the very rule that specifically governs the outcome here, the "at-the-well" rule.

The Sixth Circuit's opinion in *Poplar Creek* affirmed a well-reasoned opinion by Judge Van Tatenhove, the U.S. District Court for the Eastern District of Kentucky in Pikeville. *See Poplar Creek Development Co. v. Chesapeake Appalachia, L.L.C.*, 7:08-CV-00190-GFVT, 2010 U.S. Dist. LEXIS 74269 (copy of Opinion attached as Appendix F). Both the District Court and Sixth Circuit opinions in *Poplar Creek* applied **existing Kentucky law**. *See Poplar Creek*, 636 F.3d at 244 ("we hold that **Kentucky** follows the 'at-the-well' rule, which **allows for the deduction of post-production costs prior to paying appropriate royalties**") (emphasis added); *Poplar Creek*, 7:08-cv-00190-GFVT, 2010 U.S. Dist. LEXIS 74269 at *17 (noting that the decision to allow deduction of post-production costs is in accord with existing Kentucky law, and also citing four Kentucky cases in support, all discussed *supra*).

The district court's decision in *Poplar Creek* was followed by Judge Caldwell in *Thacker v. Chesapeake Appalachia*, 695 F.Supp.2d 521 (E.D. Ky. 2010).[13] More recently, the U.S. Bankruptcy Court for the Western District of Kentucky also followed *Poplar Creek* and rejected Appellants' position, in the case of *In re KY USA Energy, Inc.*, 448 B.R. 191 (Bankr. W.D. Ky. 2011). In that case the bankruptcy court analyzed the *Poplar Creek* opinion, found that it was "dispositive" of the issues, and noted that the result in that case was supported by extensive analysis of Kentucky law.[14] "Kentucky follows the 'at-the-well' rule which allows for the deduction of post-production costs before the payment of royalties on an oil and gas lease . . . ." 448 B.R. at 196 (granting summary judgment on the same legal issues presented here).

D. Why the majority of other states also follow the same rule as Kentucky.

Appellants are not forthright enough to admit that they are asking this Court to work a sea-change of long-established Kentucky law. Despite all of the Kentucky authorities discussed above, recognizing that Kentucky does indeed follow the "at-the-well" rule, Appellants contend that the issue has never been fully examined and that the "marketable product" concept should be recognized. As discussed earlier, the "marketable product" concept is completely at odds with the "at-the-well" rule that Kentucky clearly does follow. It is not possible to follow both. This

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[13] The *Poplar Creek* and *Thacker* cases were consolidated for decision by the Sixth Circuit.

[14] The present case involves exactly the same issues as *Poplar Creek* and *In Re Ky USA Energy, Inc.*, issues so clear under existing Kentucky law that neither of those federal courts sought any guidance from this Court (and, indeed, the bankruptcy court expressly declined to do so, seeing no valid dispute or question to be answered). This is an important distinction from the severance tax case (*Appalachian Land Company*) also before the Court, where the Sixth Circuit does seek this Court's guidance on the statutory issue that is not part of this case. Whatever this Court decides in that case should have no logical bearing on this one, where severance taxes and the statute are not involved.

Court should not, under the guise of grammar or syntax that Appellants urge, depart from decades of firmly established precedent.

Moreover, Magnum Hunter's method of calculating market price at the well is not only consistent with existing Kentucky law, it is consistent with the law of most other states that have considered the issue in the context of leases with similar language. *See* 99 A.L.R. 5th 415, *supra* ("Most cases have allowed the oil and gas lessee to deduct [post-production] costs from royalty payments"). Among the states adopting the rule applied by Kentucky courts are: California (*Atlantic Richfield Co. v. California*, 214 Cal.App.3d 533 (Cal. App. 1989)); Louisiana (*Merritt v. Southwestern Elec. Power Co.*, 499 So.2d 210 (La. App. 1986)); Mississippi (*Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984) (applying Mississippi law)); Michigan (*Schroeder v. Terra Energy, Ltd.*, 565 N.W.2d 887 (Mich. App. 1997)); [15] Montana (*S Bar B Ranch v. Ominex Canada, Ltd.*, 942 F.Supp.2d 1058 (D. Mont. 2013) (applying Montana law)); North Dakota (*Bice v. Petro-Hunt, L.L.C.*, 768 N.W.2d 496 (N.D. 2009)); Pennsylvania (*Kilmer v. Elexco Land Services, Inc.*, 990 A.2d 1147 (Pa. 2010); Texas (*Judice v. Mewbourne Oil Co.*, 939 S.W.2d 133 (Tex. 1996)); and Utah (*Emery Resource Holdings, LLC v. Coastal Plains Energy*, 915 F.Supp.2d 1231 (D. Utah, 2012) (applying Utah law).

The soundness of the rule applied by the Kentucky courts and used by Magnum Hunter here has been explained by the opinions of these other state courts. Numerous cases make the

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[15] The rule applies in Michigan only to leases entered into on or before March 28, 2000. Leases after that date are subject to a state statute addressing post-production costs. *See* Mich. Comp. L.S. § 324.61503b. It is significant that to the extent the state of Michigan decided to change leasehold property rights, it did so via the legislature, not the judiciary. Kentucky similarly requires that such a sweeping change to property rights be carried out, if at all, by the General Assembly. *See Hubley's Guardian v. Wolfe*, 82 S.W.2d 830, 835 (Ky. 1935) ("A rule established for many years should be changed, if at all, by the Legislature, where business and property rights have been conformed to it.").

same points, which are that deduction of post-production costs is the most logical reading of the Leases, is fairer to both sides, and is consistent with basic economic principles.

The logic of the "at the well" approach was recognized in *Schroeder v. Terra Energy, Ltd.*, 565 N.W.2d 887 (Mich. App. 1997), which examined whether a lease providing for payment of a royalty based on "gross proceeds at the wellhead" allowed deduction of post-production costs.

> In this case, the use of the language 'gross proceeds at the wellhead' by the parties appears meaningless in isolation because the gas is not sold at the wellhead and, thus, there are no proceeds at the wellhead. However, if the term is understood to identify the location at which the gas is **valued** for purposes of calculating a lessor's royalties, then the language 'at the wellhead' becomes clearer and has a logical purpose in the contract. In construing 'wellhead' thusly – in a manner that seeks to accord reasonable meaning to the plain language of the contract – we believe that it necessarily follows that **to determine the royalty valuation, postproduction costs must be subtracted from the sales price of the gas where it is subsequently marketed.**

Id. at 894 (emphasis added). That is exactly the calculation used by the Kentucky court in *Cumberland Pipe Line, supra.*[16]

Indeed, solid reasons abound why courts in other jurisdictions have rejected the marketable product concept urged by Appellants and follow the "at-the-well" approach. Many of these are discussed at length in Keeling and Gillispie, *The First Marketable Product Doctrine:*

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[16] Similarly, in *Atlantic Richfield Co. v. State of California*, 214 Cal.App.3d 533 (Cal. App. 1989), it was recognized that it is "commonly understood" that "market price at the well" is often determined by working back from the price at the point of sale, deducting the cost of processing and transportation to the wellhead, to determine "market value at the wellhead." *Id.* at 541. Indeed, as noted earlier, this understanding of the definition of "market value at the well" is so common it can properly be called the dictionary definition of the term. *See* Black's Law Dictionary, *supra* (and at Appendix C).

Just What Is The "Product"?, 37 St. Mary's L.J. 1 (2005) at * 81. Those of particular importance to Kentucky are summarized as follows:

(1) <u>Respect for precedent and certainty in the law.</u>

The marketable product approach advocated by Appellants "'stands in sharp contradiction to longstanding judicial precedent.'" 37 St. Mary's L.J. 1 at * 81, n. 311 (quoting from Marla J. Williams et al., *Determining the Lessor's Royalty Share of Post-Production Costs: Is the Implied Covenant to Market the Appropriate Analytical Framework?,* 41 Rocky Mtn. Min. L. Institute 12:04(1) at 12-17 (1995)). "[C]ourts have historically found the workback method to be 'particularly useful. ...'" *Id.* at n. 129. The fact that the "marketable product" concept has "clouded" and "uprooted established jurisprudence" (37 St. Mary's L.J. 1 at * 81-82) is not a good thing, especially since it replaces those decades of precedent with murky analysis and completely unpredictable, inconsistent, and uncertain outcomes. *Id.* This problem is even recognized by the only scholarly commentary cited in Appellants' brief, which concludes that the adoption of the marketable product approach has resulted in an inability of lessors and lessees to determine how royalty should be calculated, and that the marketable product approach "will continue to result in litigation" concerning royalty calculation in the states that have adopted it. Kirk, *Variations in the Marketable-Product Rule from State to State,* 60 Okla. L. Rev. 769, 815-16 (2007).

Kentucky, of course, shares this same respect for legal certainty and precedent. While this Court does not blindly adhere to past precedent, it remains "mindful of the constraints of *stare decisis* and the call that changes to the law ... 'should occur only after a judicious Darwinian process.'" *Allen v. Commonwealth*, 395 S.W.3d 451, 463 (Ky. 2013), quoting from *Fisher v. Duckworth*, 738 S.W.2d 810, 813 (Ky. 1987). While the Court in *Fisher* was referring to the law of evidence as having "evolved carefully and painstakingly over hundreds of years", (738 S.W.2d at 813), the same evolutionary process of *stare decisis* itself was detailed at length by the dissent in *Matheny v. Commonwealth*, 191 S.W.3d 599, 614-20 (Ky. 2006). As explained by the United States Supreme Court in *Morange v. States Marine Lines, Inc.*, 398 U.S. 375, 403 (1970):

> Very weighty considerations underlie the principle that courts should not lightly overrule past decisions. Among these are the desirability that the law furnish a **clear guide** for the conduct of individuals, to enable them to plan their affairs with assurance against untoward surprise; the importance of furthering fair and expeditious adjudication by **eliminating the need to relitigate** every relevant proposition in every case; and the necessity of maintaining **public faith in the judiciary as a source of impersonal and reasoned judgments.**

Id. (emphasis added). All of these considerations are implicated here. It would be an "untoward surprise" indeed if decades of Kentucky jurisprudence were suddenly abandoned by the judiciary after the business of individuals had been conducted under the clear guidance of firmly established prior law.

(2) <u>Concern for property rights</u>

Another reason the "first marketable product" approach has been rejected is because it fails to recognize that oil and gas leases grant property rights, as well as contractual rights. 37 St. Mary's L.J. at * 83. "[A]n oil and gas lease is an interest in real property," and "[t]he law applicable to oil and gas leases is that applicable to land." *Ralston v. Thacker*, 932 S.W.2d 384 (Ky. App. 1996) citing *Union Gas & Oil Company v. Weideman Oil Company*, 277 S.W. 323 (Ky. 1925) and *Piney Oil & Gas Company v. Allen*, 32 S.W.2d 325 (Ky. 1930). The doctrine of *stare decisis* applies with the most force where parties have acquired property rights – such as oil and gas leases – in reliance on a particular rule of law, such as Kentucky's consistent adherence to the at-the-well rule. As explained in *Liberty Nat'l Bank & Trust Co. v. Loomis*, 121 S.W.2d 947 (Ky. 1938):

> The principles upon which [stare decisis] rests are twofold – one to preserve the harmony and stability of the law, and the other to make as steadfast as possible judicially declared principles affecting the *rights of property*. Neither of them imposes an imperative requirement against overruling prior erroneous opinions of the same court involving the same question; but the second principle upon which the doctrine rests places upon courts a far greater mandatory requirement to continue to adhere to its prior decisions…
>
> [Courts] are much more reluctant to depart from the law as declared in a prior opinion when such declaration affects individual *property rights* and commercial transactions whereby such rights are acquired.

Id. at 949 (emphasis supplied by the Court). As demonstrated in the *amicus* brief of the Kentucky Oil and Gas Association, numerous property rights have been acquired based on a decades-long understanding that Kentucky follows the "at-the-well" rule as a matter of both contract and property law. The rule cannot therefore be overturned unless all of the decisions adopting it were "wholly without reason," and it created a "clearly manifested injustice," or was "detrimental to the public." *Loomis,* 121 S.W.2d at 949. None of these conditions exists here. The numerous prior state and federal opinions articulating Kentucky's at-the-well rule are carefully reasoned and are consistent with the majority rule in other states and the great weight of scholarly commentary on the issue. No injustice will result if Kentucky continues to adhere to the rule, and, as explained in section 7, *infra*, the rule is beneficial, not detrimental, to the public. As such, the property law reflected in the at-the-well rule prevailing in this Commonwealth for some 85 years should not be disturbed.

(3) <u>Application of contract law</u>

The "marketable product" approach also runs fundamentally counter to basic contract principles. 37 St. Mary's L.J. 1 at * 83-84. Specifically here, Appellants would have this Court ignore firmly established Kentucky contract law by (a) implying covenants that are contrary to the express language of the parties' written agreements; and (b) construing the leases against Magnum Hunter even though they agree that no ambiguity exists.

(a) <u>No implied covenant to create a marketable product</u>

Appellants state boldly that where a lease does not contain express provisions creating duties to accomplish the lease's purpose, "the law will imply them." (Brief for Appellants, p. 21), citing *Warfield Natural Gas Co v. Allen*, 248 Ky. 646, 59 S.W.2d 534 (Ky. 1933).[17] That is not a complete or accurate statement of Kentucky law. The 1933 *Warfield* opinion involved only a duty **to market**, which Appellants admit Magnum Hunter has done. *Warfield* (1933) stands only for the proposition that a "lessee will not be permitted to hold the land for speculative or other purposes for an unreasonable length of time." *Gregory v. Sohio Petroleum Co.*, 261 S.W.2d 623, 625 (Ky. 1953). The court in that same case cautioned as much against "the extravagant expectations of the lessor [Appellants, here]" as "the unreasonable timidity of the lessee" in holding leases for speculation instead of developing the resources. *Id.* Here, the duty to market has been satisfied, but with the "extravagant expectations" of Appellants taking a different form: the insistence that Magnum Hunter bear all of the costs, contrary to long-established Kentucky law.

Indeed, there will be no implication of any covenant under Kentucky law except "according to reason and justice" that which is needed to carry out the contract the parties themselves have made. *Eline Realty v. Foeman,* 252 S.W.2d 15, 18 (Ky. 1952).

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[17] This 1933 case is related to the 1935 *Warfield* case discussed above, but is not the same decision. The 1935 decision is reported at 88 S.W.2d 989 and, as explained earlier, specifically rejects the argument Appellants make here (that royalty should be based on the ultimate sale price, instead of working backwards to find the value at the well).

> The law also implies an agreement that neither party shall do anything which will destroy or injure the other party's right to receive the fruits of the contract.

Id. This countervailing covenant – not to deprive the other party of its benefit of the bargain – leaves no room for Appellants' argument that the Leases should now be judicially changed. While a duty **to market** may be implied (and has been satisfied), a purported duty to **create a marketable product** is something else entirely and has no support in Kentucky law.

> While it is true that under some circumstances there exists an implied covenant in oil and gas leases that a reasonable attempt will be made to explore and develop the resources, **there is no room for an implied covenant** where the lease agreement itself [provides otherwise].

Oliver, supra, 732 S.W.2d at 511 (emphasis added). Here, where the Lease **expressly** provides for royalty to be based on "market value at the well," there is no room for an **implied** covenant to create a different formula, based on "marketable product."

(b) <u>No ambiguity</u>

Similarly, Appellants argue that the Leases should be construed against Magnum Hunter, but they also insist "that 'market price at the well' contained in the Leases is free from doubt. …'" (Brief for Appellants, p. 23.) Appellants cannot have it both ways. If no party is arguing that the phrase is ambiguous (and no party is)[18], the Court will not resort to rules of construction.

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[18] To the extent the amicus brief filed by the National Associate of Royalty Owners ("NARO") argues ambiguity, NARO is not, of course, a party to the appeal. The "factual" scenarios made up by NARO are just that: made up. There is no record (or other) support for any of the broad statements in that brief (such as "key 'industry terms' have little or no meaning to the average Kentucky landowner"). (NARO Brief, p. 3). The Brief was apparently written by J. Curtis Edmondson, an Oregon attorney who appears to be a board member of NARO, and who has not been admitted in Kentucky. Although the Brief tendered August 27 says his *pro hac vice* admission is "pending" (NARO Brief, p. 9), there is no record, months later, of any *pro hac vice* motion ever having been filed for Mr. Edmondson, at least as of today's date, October 13, 2014.

E.g., *Hazard Coal Corp. v. Knight*, 325 S.W.3d 290, 298 (Ky. 2010) (in "the absence of ambiguity a written instrument will be enforced strictly according to its terms").

There is no issue of ambiguity before the Court. The issue was not raised or preserved below and no one is arguing it now. Appellants' invitation for the Court to nevertheless construe the Leases against Magnum Hunter is not supported by Kentucky law.[19]

(4) Other overlapping concerns

Some additional concerns about the "marketable product" approach experienced in other jurisdictions overlap with those just discussed. *See, e.g.*, 37 St. Mary's L.J. 1 at * 85-98 (identifying and discussing at length such problems as the failure to give effect to the plain terms of a standard royalty clause; the implication of covenants where they have never existed; and other serious flaws in the approach). As the Kentucky cases discussed above demonstrate, these concerns are particularly applicable to Kentucky and put the "marketable product" concept completely at odds with various large bodies of Kentucky law, including oil and gas cases; property cases; contract cases; and the law of *stare decisis*. Appellants ask too much when they ask this Court to ignore and set aside so much firmly established precedent in so many different areas of Kentucky law.

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[19] Even Appellants' argument that the Leases must be construed against Magnum Hunter was made for the first time on appeal, and therefore cannot be considered. *Ten Broeck Dupont, Inc. v. Brooks,* 283 S.W.3d 705, 738 (Ky. 2009). The argument is also misplaced because a contract is construed against its drafter only as a last resort, in cases of ambiguity where the meaning of the agreement cannot be determined by its plain language or any other method of interpretation. *Elliott v. Pikeville Nat'l Bank & Trust Co.*, 128 S.W.2d 756, 760 (Ky. 1939). Here, as Appellants concede, the key language of the Leases is not ambiguous.

(5) To avoid confusion between "market" and "market value" and "marketable product"

As noted earlier, the flaw in Appellants' logic is that they confuse **market** with **marketable product**. The fact that there is no market at the well does not mean the product is not marketable. Indeed, Kentucky law recognizes that many natural resources, such as coal and timber, require **valuation** to occur elsewhere because the **market** is elsewhere, even though coal and timber are certainly marketable products. *See, e.g., Cumberland Pipe Line*, 15 S.W. at 284, citing *Campbellsville Lumber* (timber) and *Log Mountain Coal Co.* (coal).

This is essentially the same fatal flaw in reasoning that has caused other jurisdictions to recognize the difference between "market" and "market value." *See* discussion and authorities collected at 37 St. Mary's 1 * 90-91.

> The term "market value" does not require the presence of actual buyers or a real market.

Id. citing numerous cases at n. 340 and n. 342 and the Uniform Commercial Code itself, § 2-723. Indeed, KRS 355.2-723 ("Proof of Market: time and place") specifically anticipates cases where market price must be established **in the absence** of an actual prevailing price and expressly provides that "proper allowance" for the cost of transport is to be made.

The flaw in Appellants' argument is all the more apparent when one considers how the marketable product approach they advocate would apply to any other commodity or natural resource that is valued where it is produced, but sold elsewhere in a refined state at a higher price. Suppose, for example, a landowner leases a garden plot to a farmer, and the lease agreement requires that the landowner be paid a royalty of "1/8 of the market price of tomatoes on the vine." If the grower of those tomatoes harvests them, then dries them, cans them, and trucks them to a grocery store where they sell at $4 per can as gourmet sun-dried tomatoes, the landowner could not reasonably argue that he is entitled to 1/8 of the retail price of each can.

Rather, if no market existed for the tomatoes in the field or on the vine, the law would require that the farmer's costs in drying, canning, and trucking the tomatoes to the grocery store be deducted to arrive at the price on the vine. Similarly, if the owner of diamond reserves leases his diamonds for "1/8 of the market price in the ground," but the diamonds could only be sold at a jewelry store after they are cleaned, cut, polished, and flown to the jewelry store, the landowner could not demand that he receive 1/8 of the price of every ring or necklace containing diamonds originating from his property.

There is no reason that a different rule should apply to the valuation of natural gas at the well than applies to the valuation of other commodities. In each scenario, the result is the same – a commodity is produced and its value is set at a particular place ("on the vine," "in the ground" or "at the well"). When the commodity is sold for a much higher price after it is improved and transported, the costs of these improvements must be taken into account in determining what the value was before those things occurred.

This logical, and widely accepted, method of calculating value across numerous fields of commerce does not somehow take anything away from Appellants, or otherwise burden their royalty interest, as they appear to suggest throughout their brief. As explained many years ago by a court applying Louisiana law (which, as discussed above, tracks Kentucky's on this point):

> [I]n determining market value[,] costs which are essential to make a commodity worth anything or worth more must be borne proportionately by those who benefit. To put it another way: in the analytical process of reconstructing a market value where none otherwise exists with sufficient definiteness, all increase in the ultimate sales value attributable to the expenses incurred in transporting and processing the commodity must be deducted. The royalty owner shares only in what is left over, whether stated in terms of cash or an end product. In this sense he bears his proportionate part of that cost, but not because the obligation (or expense) of production rests on him. Rather, it is because that is

> the way in which Louisiana law arrives at the value of the gas at the moment it seeks to escape from the wellhead.

Freeland v. Sun Oil Co., 277 F.2d 154, 159 (5th Cir. 1960). This same principle was recently reaffirmed just this summer by the same court, this time applying Texas law (which, like the law of Louisiana, is in accord with the law of Kentucky on the calculation of natural gas royalties):

> The deduction of post-production costs incurred between the wellhead and a downstream point at which market value could be ascertained was nothing more than a method of determining market value **at the well** in the absence of comparable sales data at or near the wellhead. The value of the gas, and therefore the value of the royalty, was not reduced.

Potts v. Chesapeake Exploration, L.L.C., 760 F.3d 470 (5th Cir. 2014) (emphasis added).

(6) <u>To avoid creating windfall</u>

In construing contracts, Kentucky courts seek to avoid an unintended windfall that neither party contemplated. *See e.g.*, *Lawson v. Menefee*, 132 S.W.3d 890, 895 (Ky. App. 2004); *McClure v. Young*, 396 S.W.2d 48, 52 (Ky. 1965). To avoid such a result in similar cases, courts have recognized that basic fairness requires a lessee such as Magnum Hunter to apportion post-production costs. As explained by a Louisiana court:

> The lessee cannot be taxed with the whole cost of marketing the gas.... Since marketing the minerals benefits both the lessee and the royalty owner, the royalty owner should bear a proportionate share of the marketing costs. Production is futile without distribution of the product.

Merritt v. Southwestern Elec. Power Co., 499 So.2d 210, 214 (La. App. 1986). Similarly, the Michigan Court of Appeals stated in *Schroeder:*

> [T]o accede to plaintiffs' interpretation of 'gross proceeds at the wellhead' would be to require defendant to pay royalties to plaintiffs, based not only on the value of the gas at the wellhead, but also upon the costs that defendant has incurred to prepare the gas for, and transport the gas to, market. Thus, plaintiffs' royalties

> would be increased merely as a function of defendant's own efforts to enhance the value of the gas through postproduction investments that it has exclusively underwritten. We simply do not believe that such an interpretation of the disputed term is more compatible with either the plain language of the agreement or with the logical expectations of the parties to the agreement.

565 N.W.2d at 894.

Under Appellants' approach, Magnum Hunter would bear 100% of the costs incurred in gathering, compressing, and treating the gas, while Appellants would bear none; yet Appellants would still obtain the benefit of the increase in the sales price of the gas resulting from Magnum Hunter's effort and cost. As courts in other states have recognized, this is unfair in any case, but particularly where Appellants have expressly contracted to receive a royalty paid only on the value of the gas "at the well" as that term had been used and understood as the dictionary definition for many decades.[20]

The Court in *Schroeder* also noted that Kentucky's approach to royalty valuation, as explained in *Cumberland Pipe Line*, makes economic sense. In upholding the deduction of post-production costs, the *Schroeder* court cited favorably an earlier Michigan Attorney General opinion which relied heavily on *Cumberland Pipe Line* and stated:

> The view of the Kentucky court [in *Cumberland Pipe Line*] appears eminently logical and is consistent with economic theory which holds that transportation from the point of origination to the market augments the value of a commodity, and that the increment of added value conferred upon the commodity by the transportation is reflected in the higher price it commands at the market place.

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[20] The unpublished *Holly Creek* case cited in Brief for Appellants at pp. 20-21 does not involve any issue even remotely connected to this case, as it addressed only the burial of a pipeline (and nothing to do with calculation or payment of royalty). There is no room for discussion of "implied covenants" here, where the parties expressly agreed to "at the well" valuation. See discussion of Kentucky cases at 23-25, *supra*.

565 N.W.2d at 895.

Simply "doing the math" on Appellants' position reveals the significant windfall they seek via a judicial re-write of the Leases. Indeed, the math demonstrates that if Appellants' position were adopted they would sometimes receive a royalty "share" of more than 100% of the well-side value of the gas.

That is exactly the problem with the example on page 4 of Appellants' brief. There, Appellants state that gas was sold for $4.15 per unit, but only after $3.65 per unit was expended to get that gas to market. Under this example, Kentucky law and basic economics dictate that the gas is worth $0.50 per unit "at the well." The Leases provide Appellants are entitled to 1/8 of the market price at the well. One-eighth of 50 cents is approximately 6 cents. Thus, if gas is worth 50 cents at the well, Appellants are due a little over 6 cents, and Magnum Hunter keeps just under 44 cents. This is illustrated as follows:

Valuation of Gas ("Market Price at Well"):
$4.15 (price at point of sale)
- $3.65 (cost to get gas to point of sale, borne initially by Magnum Hunter)
$0.50 (market value at well, upon which royalty is paid)

→

Calculation of Lessors' Royalty and Magnum Hunter's Proceeds
$0.50 (market value at well) x 0.125 (1/8)
$0.0625 (Lessor's Royalty)
$0.50 (market value at well) x 0.875 (7/8)
$0.438 (Magnum Hunter's proceeds)

But Appellants argue that, no, they are entitled to a 1/8 royalty based on the $4.15 price at a distant point of sale, despite agreeing to the price calculated at the wellhead. Thus, Appellants contend, they are entitled to 1/8 of $4.15, or $0.51 for every unit, regardless of what the gas is actually worth at the well. In the example Appellants cite on page 4 of their brief, they would be receiving **a royalty of 51 cents on gas that is only worth 50 cents** "at the well," the very place Appellants agreed the gas would be valued.

Thus, using Appellants' approach, they would receive more from each sale of gas than Magnum Hunter does. This bears no resemblance to what the parties agreed to when they executed the Leases, which was that Appellants would only receive 1/8. Appellants want 1/8 of one thing ($4.15) and want Magnum Hunter to have 7/8 of another (50 cents).

The parties obviously did not contemplate that the lessor would receive a royalty "share" of **101%** of the value of the gas at the well when they explicitly used the term "one-eighth." Nor did the parties contemplate that the sales price would be valued far from the well when they in fact used the phrase "at the well" to set the valuation point. Nor would anyone contemplate that the lessor to an oil and gas lease would actually receive the *greater* share of the proceeds of the operation when the lease assigns to the lessor only a one-eighth share. Yet Appellants ask this Court to re-write their Leases in just this manner. When one simply does the math to see what Appellants are really asking for now, and reads the Leases to see what the parties actually said then, it is apparent that Appellants' position is contrary to the terms of the Leases, ignores the reasonable expectations of the parties, and defies the rules of basic economics and common sense.

(7) Public policy

Also as recognized in the *St. Mary's* article, the "marketable product" approach promotes bad public policy. "The first marketable product doctrine ... creates the prospect for decreased domestic production and increased costs" at a time "when public policy should favor rules of law that would increase domestic oil and gas production and decrease post-production costs" both for sound economic reasons and for national security reasons (to decrease dependence on foreign oil). *Id.* at 98-99.

Kentucky law leaves no doubt on this policy issue. It is the express "public policy of this Commonwealth" to "encourage exploration for [all mineral] resources . . . and to encourage the maximum recovery of oil and gas from all deposits thereof . . . ." KRS 353.500(1). Yet Appellants' approach would reduce the economic incentive to develop leases containing gas that must be transported, compressed, or treated. This factor has been considered by courts in other states addressing the issue. *See e.g.*, *Atlantic Richfield Co.*, *supra*, at 542 (interpreting "market value at the well" to permit deduction of post-production costs as not only reasonable and correct, but also encouraging development).

In Kentucky, the public policy concerns go even further:

> [C]ontracts voluntarily made between competent persons are not to be set aside lightly, and … the right of private contract is no small part of the liberty of the citizen … [P]ublic policy (will) not bar enforcement of a contract unless it clearly appears that [the] contract has as its direct object and purpose a violation of [law].

State Farm Mut. Auto Ins. Co. v. Hodgkiss-Warrick, 413 S.W.3d 875, 881 (Ky. 2013) (quotation marks omitted). As in *State Farm*, public policy does not bar enforcement of the contracts at issue.[21]

Thus, public policy strongly weighs in favor of, not against, affirming the decisions in this case. All of the law that permits the calculation of royalty as done in this case also promotes important public policy. In addition, certainty in the law, long established precedent regarding

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[21] The amicus brief filed by the National Association of Royalty Owners (NARO) is very thin on law and is directed instead **only** to a public policy argument, urging this Court to rewrite the terms of the Leases because "the average landowner is typically not an active participant in the oil and gas industry." (NARO Brief, p. 3). These vague overly broad statements are not supported by any record, but this is not the kind of public policy that would justify disregarding a contract's terms in any event. *State Farm,* 413 S.W.3d at 881.

property rights, and efficacy of contracts are all vital policy concerns that would be ill-served by the sweeping changes Appellants seek here.

III. THE CIRCUIT COURT PROPERLY FOUND THAT THE LEASES REMAIN IN EFFECT.

Appellants also alleged that, if the gas produced from their property cannot actually be sold at the wellhead, then it is not being produced "in paying quantities," as required to extend the Leases beyond their primary term. (See Complaint at ¶ 18.) This argument lacks any foundation in the Leases or Kentucky law and must be rejected.

Simply put, whether an oil or gas lease produces "in paying quantities" has nothing to do with whether the product is marketable "at the well" or at some distance from the well after it is subsequently transported or treated to make it marketable. Instead, "[i]n this jurisdiction production in 'paying quantities' . . . is held to mean such quantities as are susceptible of division between the parties and as will yield a royalty to the lessor that justifies the occupancy of and interference with his use of his lands by the operations." *Warfield Natural Gas v. Allen*, 59 S.W.2d 534, 538 (Ky. 1933). See also *U.S. v. 2,847.58 Acres of Land, More or Less, In Bath, et al. Counties*, 529 F.2d 682 (6th Cir. 1976) (recognizing that *Warfield* is the prevailing law in Kentucky on the issue of production in "paying quantities"). Thus, if there is a sufficient amount of production to pay Appellants a royalty (which is conceded on the face of the Complaint), then the Leases are producing in "paying quantities" and are kept alive by production.[22]

Here, Appellants admit that Magnum Hunter continues to produce gas on the Leases, and that they are being paid a royalty. (*See* Complaint at ¶ 12 (". . . gas is being produced in the

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[22] The *Cumberland Contracting* case cited by Appellants is distinguishable because it involved "the inescapable conclusion" that an oil well had been held for eleven years solely for future speculation, not present production.

extended term."); ¶ 13 (". . . Defendant commenced the payment of royalties on the gas produced and sold therefrom.").) Appellants' own allegations defeated their claim that gas is not being produced in paying quantities, and this claim was properly dismissed under Kentucky law.

Appellants' claim is all the more flawed because the Lease provisions in this case do not even mention the term "paying quantities." In addition to Appellants having conceded in their pleadings that there was production in "paying quantities" (as that term is defined under Kentucky law), the Lease excerpts in the Complaint actually say that the Leases are extended so long as gas is "produced." Where, as here, the term "produced" is used without the qualifier of "paying quantities," even a small amount of production will extend the Leases. As noted by the court in *Enfield v. Woods*, 248 S.W. 842 (Ky. 1923):

> It will be observed that the lessee is not required in specific terms to produce oil in paying quantities but he is required to produce oil or gas, one or the other, from the premises. This, of course, means a production of oil or gas in such quantities as to be susceptible of division, so as to pay the landowner a royalty, even though small. A mere showing of oil is manifestly not sufficient even though produced. The production must be tangible and substantial, but it need not be great.

Id. at 843. A leading treatise on oil and gas law also explains Kentucky law on this point. When the lease does not specifically require production in paying quantities "a lease may be preserved in the secondary term by **any** production, whether or not in paying quantities . . . ." Williams and Meyers, *Oil and Gas Law* § 604.5 at n. 3.1 and accompanying text (citing *Wheeler & Lemaster Oil & Gas Co. v. Hensley*, 398 S.W.2d 475 (Ky. 1965) (emphasis added). *Warfield* also states that the "discretion and judgment of the lessee will be accepted as conclusive" as to whether paying quantities exist. 59 S.W.2d at 537.

Whether the Court reads the Leases to require production "in paying quantities" (as Appellants request) or reads the Leases as written (as required by law), the courts below properly ruled that the Leases remain in effect under Kentucky law.

Perhaps because the law of our state is so clear, Appellants do not cite a single Kentucky case holding that there can be no paying "quantities" unless the gas is of such "quality" that it is "marketable" right at the wellhead. Appellants' argument on this point has also been rejected in Texas, a jurisdiction from which Appellants do cite some authority. (*See* Appellant's brief at p. 26 citing *Clifton v. Koontz*, 325 S.W.2d 684, 691 (Tex. 1959)).[23] Addressing an argument very similar to the one made by Appellants here, the court in *Blackmon v. XTO Energy, Inc.*, 276 S.W.3d 600 (Tex. App. Waco 2008) rejected the notion that gas must be salable at the wellhead in order for it to be produced in paying quantities. In *Blackmon*, the gas from a well could not be sold unless an amine plant was constructed to remove carbon dioxide from the gas so that it could be sold under the under the lessee's gas sales contract. The lessors argued that the well was not capable of production in paying quantities if it did not produce "marketable gas" at the well, without subsequent treatment. The Texas court rejected this argument, stating that in a "paying quantities" analysis "[t]he focus is on whether the well is capable of producing gas in a marketable *quantity*, not a marketable *quality*." *Id.* at 603 (emphasis in original). The court concluded that because "raw gas was capable of flowing from the wellhead…in a marketable

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[23] Appellants' quotation from *Koontz* does not help them either. That "paying quantities" requires the "ability to market the product" does not mean that the product must also be marketable at the wellhead, and *Koontz* says nothing like this. *Koontz* simply says that there must be the ability to market the gas at a profit "even if small over operating expenses" and even if the well "may never repay its costs, and the enterprise as a whole may prove unprofitable." Here, it is beyond dispute that Magnum Hunter *does* have the ability to market the product and *is* marketing the product in such a manner as to pay the Appellants a royalty. Complaint ¶¶ 12, 13. Thus, even if "ability to market" the gas is a factor in determining paying quantities, Magnum Hunter easily satisfies it in the present case.

quantity regardless of whether the amine processing unit was installed downstream…the well was capable of producing in paying quantities" even though the gas could not be sold until it was treated at the amine plant. *Id.*

IV. <u>APPELLANTS TRY TO CREATE A FALSE CHOICE THAT DOES NOT EXIST.</u>

Appellants try to create a false choice by saying that the Court must either rule that there is no market for selling gas at the well where it is drilled (and thus, they say, it is not possible to have "paying quantities") <u>OR</u>, they say, rule that there is a market price "at the well" on which royalty must be calculated before any costs for gathering, compression, treating, and transportation are taken into account. (See Appellants' Brief, pp. 24-28.) Appellants' argument on "marketable product" and "paying quantities" is most clearly articulated in their Brief at p. 26, where they say, "You cannot have 'paying quantities' if the object cannot be sold" at the well. In other words, Appellants contend that there must be a market at the well-head; otherwise, they contend there are no "paying quantities" at that location.

This is a *non sequitur* and a completely false choice: The Leases do not say there must be a <u>market</u> at the precise place where the gas is drilled or produced, nor do the Leases say there must be "paying quantities." What the Leases say is that Defendant will pay 1/8th of the "market price at the well."

This contention that there must be a market at the wellhead was rejected by Kentucky law in 1929. As *Cumberland Pipe Line* itself noted, "There is seldom, if ever, a market at the place of production." 15 S.W.2d at 284. This does not create any dilemma because the law in Kentucky has always been that the calculation works backwards from (1) the sales price received wherever the market for gas exists, (2) less what it costs to get it there, (3) to arrive at the market value "at the well." *Id. See also Rains, supra* (holding that lessor was not entitled to 1/8th royalty based on sales price at distant market); *Warfield Natural Gas Co. v. Allen*, 88 S.W.2d at

991 (agreeing with lessee who did "not sell the gas in the field" that the calculation of 1/8th royalty was not to be based on whatever price gas was sold for at other place but only for value of gas measured and priced **as if** it were sold "at the well side").

Appellants' entire Brief is based on this false "dilemma" that Kentucky courts have long ago resolved. Even where gas is not sold "in the field," or "at the well," it is **valued** there. Appellants are trying to have it both ways, insisting there are no "paying quantities" possible if the product is not marketable right at the drilling spot, yet having accepted royalties for years on prices received at a distant market after the gas was gathered, compressed, treated, and transported to the point of sale. This inconsistent position is not allowed under Kentucky law. *See, e.g., Warfield*, 88 S.W.2d at 991 ("action of plaintiffs in repeatedly accepting checks [with royalty calculated] on that basis" defeated claim to calculate them some other way).

CONCLUSION

The decisions of the Court of Appeals and trial court should be affirmed.

Respectfully submitted,

Anne Chesnut

Anne A. Chesnut
R. Clay Larkin
Bingham Greenebaum Doll LLP
300 West Vine Street, Suite 1100
Lexington, Kentucky 40507
Telephone: (859) 231-8500
Facsimile: (859) 255-2742

Harry D. Callicotte
Magnum Hunter Production, Inc.
120 Prosperous Place, Suite 201
Lexington, Kentucky 40509
Telephone: (859) 263-3948
Facsimile: (859) 263-4228
COUNSEL FOR APPELLEE